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JAPAN-CANADA RELATIONS

Summary

Japan and Canada have maintained relatively close political and cultural relations in the modern era. Japanese emigration to western Canada was in part responsible for increased contacts, although it manifested many of the same tensions that accompanied similar migrations to California.

In recent years, Canada has played a significant but not overwhelmingly important role in the Japanese economy. Although trade balances consistently favor the Canadians, Ottawa is dissatisfied with the mix of trade and investment between the two countries. However, there is no indication that present sales of Canadian resources to Japan in return for manufactured imports are likely to alter in the near future.

Early Relations

Lured by the promise of a better life, Japanese nationals first entered western Canada in 1877. By the turn of the century, several thousand Japanese had taken up residence in western Canada, almost all of them in British Columbia. It was this movement that first stimulated active interest in diplomatic relations with Japan, although Canadian concerns were primarily negative. The "gentleman's agreement" of 1908 set a limit of 500 Japanese immigrants a year, stabilizing a potentially explosive situation. Scars from those early years, including internment during World War II, however, influenced postwar relations and even now persist.

Trade relations were marginal during this period, but gathered steam with the establishment of diplomatic relations in 1929. Official ties were terminated with the war but were quickly re-established in 1953. A 1952 trade balance overwhelmingly in Canada's favor rapidly dipped to a two-to-one margin in 1956 and has remained in Canada's favor in every year but one since then.

The Trudeau Era

Canada took greater notice of the Pacific in general and Japan in particular with the installation of the Trudeau government in 1968. The new prime minister proposed strengthening ties with Pacific nations and diversifying Canada's global trade by turning east as part of the "third option" -- a foreign relations posture designed to retain the country's historically close relationship with the United States while expanding ties in new spheres. Concerned by the extent of American influence in Canada, but realistic enough to accept the fact that such conditions were unlikely to change, the Trudeau government sought new markets for Canadian exports and broader political influence abroad through the third option. By expanding economic ties, particularly with Asia, the prime minister hoped to minimize the economic impact of the United States and make the country more self-sufficient in both political and economic terms.

Although the Trudeau government waxed enthusiastic over its new policy, realities remained virtually unchanged. While turning to Asia may have been an option for Canada, a combination of economic and political factors prevented the country from being a serious alternative import source or investment site for Japan. The most serious limitation was Tokyo's perception that the Canadian government was hostile to outside investment, as typified by the stance of the Foreign Investment Review Agency.

This agency was designed to assist foreign investment while preserving Canadian policy notions on the nature of economically desirable projects, i.e. manufacturing (or at least additional processing of mineral resources). The board was perceived, however, as a political bureaucracy shrouded in red tape, rebuffing the activities of potential investors. More importantly, the Trudeau government itself, especially in its later years, was seen by Japanese business interests as an inherently unstable and combative impediment to broader economic relations.

Consequently, the Trudeau decade failed to fulfill the optimistic proposals it offered in the late 1960s. While the third option concept in both its political and economic forms may yet prove viable, it has not affected economic realities. Investment is at traditionally marginal levels and trade patterns remain unchanged. Canada, as far as Canadians are concerned, is a minor economic colony of Japan's, supplying raw materials and providing markets for Japanese manufactured exports.

The Conservatives Enter the Picture

A few changes have taken place since the 1984 election of the Progressive Conservative government of Brian Mulroney, of which the most

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important is the reorganization of the Foreign Investment Review Agency. Now called "Investment Canada," the board is promising greater assistance to potential investors with fewer strings attached. The conservatives promise to emphasize provincial development consistent with local needs, but a more market-oriented approach to what is "suitable" or "unsuitable" for Canada. They promise further that fully 90 percent of the companies once subjected to the government's review process will be released entirely. While the government remains committed to extracting manufacturing investment from Japanese companies in theory, it is not likely to turn down offers in traditional sectors.

But the third option has apparently been retained. External Affairs Minister Joe Clark recently outlined the current government's approach to bilateral relations:

> Canadians and their new government are committed to their Pacific destiny. Our focus on the region has been strong and will remain so. We are determined to put the required policy instruments in place to advance social, economic and political cooperation. Our commitment and determination are not idle words or half-fulfilled ambition. We have a challenge to devise a clear and comprehensive strategy that places a sustained and unprecedented emphasis on the Pacific rim in general and Japan in particular as cornerstones of both our national and foreign policies.

When examining that "clear and comprehensive strategy," however, some observers have suggested that it is rhetorical. In many respects, Canada appears to be rediscovering Japan, rather than building on a strong base of economic and political ties. A combination of circumstances explains Canada's difficulties in stimulating more extensive ties with its principal Asian partner. The third option -- a clear flop -- most likely would have succumbed in any event to Ottawa's internal difficulties even if it has been more promising on the diplomatic front. Domestic economic problems in the Trudeau years, which still have not been resolved, focused attention on more fundamental problems. Unemployment reached levels exceeding 25 percent in some provinces and averaged in the double-digit column for several years in such politically sensitive areas as Quebec. (The unemployment rate remains high by any comparison at about 11 percent nationwide.)

In addition, the Quebec secession dispute may have cost the Canadian government in international relations. At one point, the fragile unity of the country seemed on the verge of unraveling to some Japanese. Many U.S. observers were equally concerned that Quebec would pull away from the federal government, leading to a series of withdrawals that would ultimately have dissolved the better part of the country. These fears did not come to pass, but the issue consumed such intense political energies and attention that Ottawa's focus on the Pacific in general and Japan in particular dimmed.

A final consideration is that Japan's economic interests in Canada, until recently, have centered on only a few of the country's 12 provinces, primarily British Columbia, Alberta and Ontario. Some analysts suggest this has given the private sector and the Japanese government little reason to be overly concerned about relations with Canada as a whole.

Canada's own confused political conditions contribute to this problem. Canadian provinces traditionally have maintained considerable autonomy, far more, most political scientists agree, than individual states in this country. Thus "Canadian" negotiating teams may include not only members of the central government but also individual representatives from one or more of the provinces affected by the talks. The resulting difficulties in presenting a unified Canadian position can well be imagined. Consider a delegation from the United States attending a Tokyo round of trade talks accompanied by the governors of all fifty states, not simply to observe the talks, but to take an active part in them. That, some say, is both the blessing and curse of Canadian nationhood, and it cannot help but influence relations with Japan.

Tokyo has not been seriously accused, so far, of trying to secure economic and political advantages by launching a "divide and conquer" strategy that pits individual provinces against one another. (That charge has been levied against the United States and West Germany.) While not a conscious policy, however, circumstances could produce the same results. It may not be necessary for Japan to pursue a national approach to Canadian economic questions as long as it cultivates friendly relations with the provinces consistent with investors' economic and political needs. The mirror image of that argument, of course, could be equally true: Canada may be incapable of drafting a unified approach toward Japan to establish, much less pursue, national economic and political interests.

Trade and Investment: Current Status

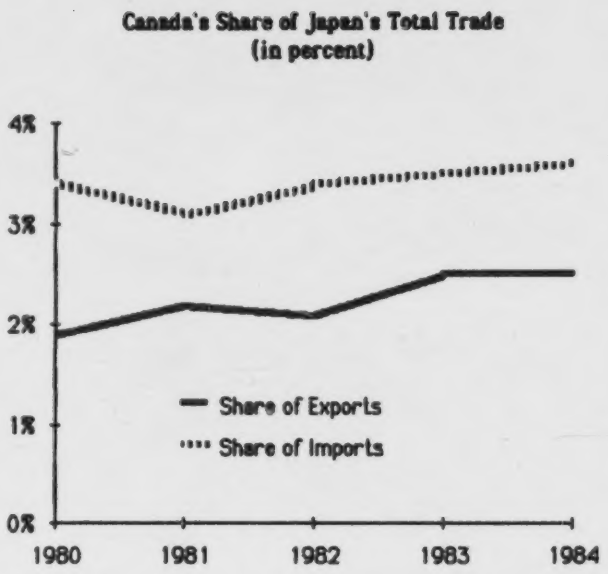
From the Japanese perspective, trade with Canada is not of overriding importance, nor is it to be neglected or taken for granted. Canada is Japan's eleventh-largest export market and seventh-largest source for imports. Overall trade ranks well behind such countries as the United States, China and Saudi Arabia. Japan exported $4.3 billion in 1984, while importing nearly $5 billion -- a comfortable amount but nothing in comparison with U.S.-Japan figures (see table).

From the Canadian side of the ocean, Japan ranks as the country's second-largest trading partner -- although a distant second to the United States. Japan's share of total Canadian trade is 5.3 percent. Canada is a major supplier of wheat, coal and other staples of Japan's industrial and consumer diets. It is not an insignificant market for Japanese automobiles, a political issue with implications similar to those afflicting the United States.

Investment between the two countries lags far behind the trade figures. Canada is the location for just $1.6 billion of Japan's total overseas direct investment, a fraction of the $19.9 billion invested in the United States and well behind the $3.2 billion directed to Australia, a country with similar political and economic concerns vis-a-vis Japan.

Not only is investment limited, but it is heavily concentrated in resource development, much to the chagrin of Canadian policymakers who have been severely critical of decisions to put money into such areas as coal mining and tar sands development at the expense of job-creating investments in manufacturing. Even some of these projects fail to please Canadian analysts.

The tar sands commitment, for example, is brushed off as "minor league stuff" by one observer, even though limited investment is doubtless better than none at all.



A potential $3 billion liquefied natural gas (LNG) project in Alberta illustrates the thrust of Japanese investment in energy-related fields. This spring, Mobil Oil Canada Ltd. announced an agreement with Petro-Canada Ltd. to establish a consortium of Canadian natural gas producers and Japan's Nissho Iwai Corp. to determine the viability of shipping LNG from Albertan and British Columbian fields to Japan. Mobil and Petro-Canada would each have a 30 percent interest in the project, Nissho Iwai and Westcoast Transmission Ltd. 15 percent each and Suncor Inc. the remaining 10 percent. The contract calls for annual shipments to Japan of 2.35 million metric tons for 20 years, beginning in 1989.

The project demonstrates the mixed blessings of trade with Japan from the Canadian perspective. Japan is likely to remain a steady customer for LNG because of its own policy emphasis on diversifying energy supplies, both in terms of supplier countries and types of energy sources. Thus, it can be counted on to retain long-term interest even though LNG may be more costly than traditional energy sources, such as Middle East oil. This should be good news, but some Canadians would still prefer to see more funds directed to the manufacturing sector.

To some degree, Canada alone can be held responsible for this situation, if indeed it is the object of strong public concern. Japan can hardly be blamed for energy resource development, given its energy needs and the fact that fully 30 percent of all investment in Canada is in energy. Tokyo, it could be argued, is simply following the outline that Canada has advanced under its National Energy Plan. This measure was drafted to stimulate exploitation of Canada's vast resources while preserving national prerogatives over the long term. The fact that it is limited in its job-creating impact is secondary to the facts of life in Canada: the country possesses immense surplus energy reserves. Exports are a sensible alternative, despite the lack of benefits in some areas and, some suggest, the damage to national pride that comes from exporting raw materials rather than finished products.

Similar arguments and concerns manifest themselves in automotive trade. Since 1981, car shipments have been limited under restraint agreements similar

Japan-Canada Trade, 1980-84*

	1980	1981	1982	1983	1984
Total Exports	$2,436.6	$3,399.0	$2,860.7	$3,624.9	$4,297.3
Crude Materials and Fuels	11.1	6.9	7.5	8.7	8.0
Light Industrial Products	317.7	380.6	318.2	407.6	480.0
Textiles	70.5	93.7	85.7	101.6	107.1
Heavy Industrial Products	2,057.6	2,969.5	2,490.0	3,157.4	3,748.9
Chemicals	77.3	91.7	88.5	110.7	116.1
Metals and Metal Products	338.0	480.9	306.1	203.0	243.9
Steel	249.8	372.0	203.4	103.5	141.9
Machinery and Transportation Equipment	1,642.3	2,396.9	2,095.4	2,843.8	3,388.9
Motor Vehicles	644.1	1,013.8	796.0	983.6	1,120.0
Power Generating Equipment	22.8	43.9	38.4	69.8	165.0
Office Machinery	46.9	61.6	66.3	116.4	115.2
Motorcycles	86.8	127.8	139.1	172.6	174.4
Scientific and Optical Equipment	149.5	181.1	115.7	147.7	183.0
Vessels	16.2	39.6	76.0	256.2	174.7
Total Imports	$4,724.2	$4,463.9	$4,440.5	$4,429.7	$4,945.1
Food	1,197.1	1,485.1	1,423.0	1,369.2	1,447.5
Wheat	322.8	348.5	285.4	309.4	314.3
Industrial Supplies	3,334.4	2,869.3	2,876.2	2,899.9	3,244.2
Crude Materials	1,979.7	1,507.3	1,394.9	1,341.2	1,404.7
Mineral Fuels	744.2	770.2	841.3	882.4	1,166.6
Chemicals	192.6	220.8	220.5	246.3	267.1
Metals	268.3	241.9	296.9	253.3	254.6
Capital Goods	132.0	62.0	96.5	76.9	102.3
Consumer Nondurables	10.4	15.7	12.6	8.1	8.0
Consumer Durables	22.9	20.6	12.8	11.4	17.8

*In millions of U.S. dollars. Exports are valued f.o.b. and imports c.i.f.

Source: Japan Tariff Association, The Summary Report: Trade of Japan

in some respects to those between the United States and Japan. Suggestions in 1985 that Tokyo would not continue the restraints raised a furor in Canadian circles. Officials ultimately agreed to a vaguely worded arrangement whereby Japan is expected to limit its exports to 18 percent of the Canadian market for the 12 months ending March 31, 1986 -- roughly 180,00 to 198,000 cars (based on Canadian government sales projections) -- or some 6 to 16 percent above the fiscal 1984 level.

Canadian officials have tied the prospect of higher import figures to increased automotive investment in Canada (see JEI Report No. 25B, June 29, 1984). At present, only Honda Motor Co., Ltd. has begun building an assembly plant for compacts in the country, due to open in 1987. Toyota Motor Corp., however, recently announced plans to build an assembly facility for subcompacts at a yet-to-be-selected site, with startup scheduled for 1988. A General Motors Corp.-Suzuki Motor Co., Ltd. joint venture has been widely rumored in Canadian industry circles, but no plans have been declared as yet.

A new complication is the emergence of Hyundai Motor Co., a Korean car manufacturer, as an exporter to Canada. Because Korea is considered a developing nation under Canada's generalized system of preferences, Hyundai faces neither restrictions nor duties on its exports there, a condition that causes considerable frustration to Japanese firms whose automobiles face a 10.7 percent tariff. This gives the Korean manufacturer a $500 to $650 price edge on its principal export to Canada, the Pony. Hyundai is also committed to investing in Canada and plans to build a $25 million parts manufacturing facility and to source 50 percent of its needs from Canadian firms. Hyundai sold only 25,000 units in 1984, but expects that number to reach 40,000 in 1985, a healthy jump equivalent to 25 percent of Japanese sales.

Some more diversified Japanese companies have also entered the Canadian manufacturing sector. Mitsubishi Electric Corp., for example, has completed work on a television tube plant in Ontario, but such cases, from Canada's viewpoint, remain few and far between and are unlikely to resolve fundamental complaints. As one observer noted on Japanese investment in the country, "it has been a long and arduous process."

A final complaint is that Japan simply will not buy Canadian manufactured goods, high-tech, low-tech or otherwise. For several years, promoters of the CANDU light-water nuclear reactor felt that Japan should be a logical market, given its strong emphasis on nuclear power generation. Japanese companies, however, favor American nuclear technology. Canadian patriots feel that Japan Air Lines Co., Ltd. (JAL) should be interested in the DASH short- to medium-range commercial airliner for domestic flights in Japan, but JAL and other domestic buyers have favored U.S. purchases when looking at overseas aircraft and increasingly may have domestic options in future purchasing decisions.

On the manufacturing side, both Canadians and Japanese alike have noted that a major obstacle to increased Canadian exports of manufactured goods to Japan is the fact that American subsidiaries dominate several industrial sectors that could export competitively to Japan. They charge that these American affiliates, when spotting a prospective sale in Japan, shift the order to the U.S. base, racking up a credit for the United States instead of Canada.

As a result, Canada's trade with Japan in manufactures suffers. (Some U.S. observers note that Canada should not complain; at least it has a surplus in its trade with Japan.)

The Triangle's Third Side: The United States

Perhaps the single most important factor in Japan-Canada relations is the fact that for both countries, the United States -- like it or not -- is the most important political and economic partner. Consequently, the U.S. factor is considered primary by both countries and decisions made by one or the other are often viewed through the U.S. lens. In investment, for example, the United States simply is a more important location for both Canada and Japan, resulting in limited investment flows between the two. The United States is the principal market for both countries, giving it greater political leverage in trade disputes than might exist otherwise. (Hence, Japan will promise a numerical limit on automobile exports to the United States, while only committing vaguely to a general market share in Canada's case.)

This is what undermined much of Prime Minister Trudeau's third option and will continue to influence the course and pattern of Japan-Canada economic relations. Indeed, the third option was defined frequently in terms of Canada's relations with the United States: neither hostile, nor overly accommodating, but distinct from the bilateral relationship. The realities facing Canada and Japan are simply put: the United States comes first for both.

Limits on Growth

Persistent economic problems add to Canada's dilemma. While trade and investment are likely to grow, Canada's persistently high unemployment, costly wage structure, strong union presence and relatively high inflation -- combined with less than dramatic economic growth -- all conspire to limit the Japanese presence in Canada. Critics say that Japan has invested in other regions of the world -- Latin America, for instance -- where investment conditions are less than favorable. But these decisions reflect private-sector priorities and the business community's judgment of the long-term market potential. From a broad perspective, the Canadian market simply may not be as important to Japan as other markets.

Consequently, the outlook for future relations, while far from bleak, may not be as rosy as some Canadians would like. Japanese economic development will continue to emphasize high value-added products in manufacturing, while diversifying and expanding in services, a growing area. Private-sector officials apparently view Canada's worth, at least for the near future, in terms of its natural resource potential with limited shifts into processing. Some Japanese processing of aluminum ingots, for example, has shifted to Canada, but such examples are limited and it is likely that for the mid-term, Japanese industry will focus primarily on mining rather than processing of raw materials or non-mining activities.

In trade terms, this assures stable markets in Japan for certain Canadian products, although trade flows could easily assume a pattern that parallels the U.S.-Japan situation. Prices on resource contracts, especially

in energy-related fields, could easily drop; at best, stable or only slightly higher prices are foreseen for the immediate future. Japanese exports to Canada, however, promise to assume greater value and diversity, suggesting that while the overall Canadian market might be limited, bilateral trade flows increasingly could tilt to Japan's favor.

Even in resources, Canada could remain simply a Japanese hedge against domestic shortfalls rather than its sole supplier, suggesting limited growth possibilities. The experiences of the oil shocks remain firmly implanted on corporate and policy memories in Japan, and the country is unlikely to consciously place itself in a position where it is entirely dependent on a limited number of suppliers. This would also dampen growth potential somewhat, even though Canada is likely to remain politically friendlier to Japan than many other governments. On the manufacturing side, Canada can forget CANDUs and DASHes. Japan seems satisfied with its present options in those sectors and related areas.

The prospects for relations in the future, then, suggest no dramatic changes. This is not necessarily a disadvantage to either country, although it falls short of Canadian hopes and expectations. Given Ottawa's relative lack of political clout vis-a-vis Japan, one must begin pondering the possible reactions of the Canadian government should its trade balance with Japan begin bleeding red for several years in succession. Many Canadians are convinced, in the words of one writer, that "Japan remains unwilling to regard Canada as anything more than a resource hinterland of the United States and is not yet disposed to consider Canada . . . as a sophisticated industrial nation, distinct and separate from the United States." While that conclusion may not accurately reflect Japanese perceptions of the relationship, it certainly suggests that more work is needed on both sides before the promises of an earlier decade come to fruition.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.